UNIT 4 CLASSICAL AND KEYNESIAN SYSTEMS*

Structure

OBJECTIVES

After going through this Unit, you should be in a position to

- bring out the salient features of classical economics;
- explain the demand for and supply of labour with the help of diagrams;
- explain the relationship between output and real wages;
- explain the concept of aggregate supply curve as per classical view;
- bring out salient features of Keynesian economics; and
- distinguish between classical and Keynesian views on the macroeconomy.

INTRODUCTION

During the 1930s the world economy was passing through severe economic crisis — there was widespread unemployment, unintended accumulation of inventories, and persistent decline in prices, output and income. The overall economic atmosphere was pessimistic. This period is termed as 'the Great Depression', because of the extent and duration of the downslide in global economic environment. There have been periodic decline in output and employment in countries; however the severity of the Great Depression is un-matched in economic history. Prevalent economic theory around that time was neither in a position to explain the ongoing developments nor to provide a solution to the problem.

The General Theory of Employment, Interest and Money (published in 1936)', which provided fresh insights to the problem. Keeping in view its radical nature of analysis, fundamentally different explanations, and distinct remedial measures it is often termed as 'Keynesian Revolution.

The Keynesian ideas further developed into a vast literature during the next three decades, which provided further insights and a new school of thought, the Keynesian economics. It was only during the 1970s that Keynesian economics lost its glory and gave way to a new school of thought, the New Classical Economics, which was a revival of classical economics. In this Unit we will discuss the salient features of classical economics and Keynesian economics.

THE CLASSICAL APPROACH

Keynes termed all economists prior to him as 'classical'. The classical period, generally taken as the period before 1930, was dominated by the work of Adam Smith (*Wealth of Nations*, 1776), David Ricardo (*Principles of Political Economy*, 1817) and John Stuart Mill (*Principles of Political Economy*, 1848). Neoclassical economists such as Alfred Marshall and A. C. Pigou extended the classical ideas. Important features of the classical ideas are as follows:

(i) **Microeconomic Issues**: Classical economists dealt mostly with microeconomic issues pertaining to behavior of economic agents such as firms and households. In classical view, a firm maximizes its profits subject to a resource constraint. Similarly, households try to maximize their utilities or economic gains given their budget constraints. Classical economists believed in the optimising tendencies of the market mechanism. Variables such as price level, wage rate and output level should be determined by market forces (supply and demand).

ii) Laissez Faire: Classical economists believed in the philosophy of 'laissez faire', which is a French term meaning 'leave alone' or 'let you do'. According to this view, there should be minimal intervention from the government in business affairs. In fact, Adam Smith suggested that government should confine itself to three main duties, viz., (i) national defense, (ii) administration ofjustice (law and order), and (iii) establishing and maintaining certain public works (infrastructure, education, etc.).

iii) Invisible Hand: Adam Smith introduced the concept of the 'invisible hand'. According to him, the economy will function well if everyone pursues his/ her own interest. "It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest."Individual pursuing self interest seem to be led by an invisible hand to maximize the general welfare of everyone in the economy. It is not the generosity of a producer in selling a commodity; it is his/her self interest. Similarly, I am not doing a favour to the producer; I am pursuing my own interest in buying the commodity. The philosophy of the invisible hand confined classical economists to the analysis of the behavior of economic agents; they failed to see any conflict between interests of economic agents and that of the economy as a whole.

iv) Continuous Market Clearing:- Classical economists assumed that prices and wage are flexible. As you know from microeconomics, equilibrium is determined at the level where supply and demand are equal. Given the supply and demand curves, if demand is more than supply, price will go up. Similarly, if supply is more than demand, price will decrease. This principle applies not only to commodities, but also to wage rate. If supply of labour is more than its demand, there will be a decline wage rate till supply of labour equates its demand. An implication of the above is that there is no unemployment in the economy- wage rate will decline till all workers are employed. There is no disequilibrium in the market.

v) Perfect Competition:- Classical economists assumed that there is perfect competition in the market so that markets function smoothly. As there is full employment production is always at the full employment level. An implication of the above is that there is no scope for ups and downs in the level of output. Going by the logic, the classical economists ruled out the possibility of business cycle.

vi) Say's Law of Market:- Classical economists believed that production or supply is the key to economic prosperity. Thus they emphasized more on the supply side of the economy. This approach is summarized very well in the Say's law, named after the prominent economists J B Say. According to J B Say, 'supply creates its own demand.' Whenever some production takes place, there is a stream of income in the hands of people, which generates demand. A person should have produced something to sell and thereby earned certain income. Thus in the classical viewpoint, there is no scope of deficiency of demand in the economy. Therefore, primary concern before an economy is production or supply, not consumption.

According to classical economists, economic growth of an economy is due to increase in the factors of production and technological advancements. Money is just a medium of exchange; and it facilitates transactions among economic agents. According to classical economists, increase in money supply does not affect the level of output- it only leads to increase in prices. They believed that there is dichotomy between monetary variable such as money supply and real variables such as output and employment. As mentioned earlier, the classical economists believed in free market systems without government intervention.